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Tax Savings for Members of the Armed Forces

Special tax benefits are provided to Armed Forces personnel. A major tax-free benefit is the combat pay exclusion. Under this exclusion, members of the Armed Forces, including active duty reservists, may exclude from gross income all compensation for active service received for any month in which they served in a combat zone or were hospitalized as a result of any wound, injury, or disease incurred while serving in a combat zone. Commissioned officers are allowed an exclusion equal to the highest rate of basic pay at the top pay level for enlisted personnel, plus any hostile fire/imminent danger pay received for the month.

Other pay benefits may be tax free, and you may be able to get filing extensions and time extensions for home residence replacements. A list of tax-free benefits may be found at ¶35.2. Filing extensions are discussed at ¶35.5.

A special law designates Bosnia and Herzegovina, Croatia, and Macedonia as a qualified hazardous duty area and treats it as a combat zone for tax purposes.

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¶35.1 Taxable Armed Forces Pay and Benefits

Armed Forces personnel report as taxable pay the following items:

- Basic pay for active duty, attendance at a designated service school, back wages, drills, reserve training, and training duty.
- Special pay for aviation career incentives, diving duty, foreign duty (for serving outside the 48 contiguous states and the District of Columbia), hazardous duty, medical and dental officers, nuclear-qualified officers, and special duty assignment pay.
- Enlistment and reenlistment bonuses.
- Payments for accrued leave, and personal money allowances paid to high-ranking officers.
- Scholarships, such as the Armed Forces Health Profession Scholarship Program (AFHPSP) and similar programs, granted after August 16, 1986.
- Student loan repayment from programs such as the General Educational Loan Repayment Program.

Community property. If you are married and your domicile (permanent home to which you intend to return) is in one of the following states, your military pay is subject to community property laws of that state: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. *See* ¶1.9 for community property reporting rules.

State income tax withholding. A state that makes a withholding agreement with the Secretary of the Treasury may subject members of the Armed Forces regularly stationed within that state to its payroll withholding provisions. National Guard members and reservists are not considered to be members of the Armed Forces for purposes of this section.

Where and when to file. Mail your return to the Internal Revenue Service Center for the place you are stationed. For example, you are stationed in Arizona but have a permanent home address in Missouri; you send your return to the Service Center for Arizona. For filing extensions on entering the service, *see* ¶35.7.

¶35.2 Tax-Free Armed Forces Benefits

The following benefits are *not* subject to tax:

- Combat pay; *see* ¶35.4.
- Living allowances for: BAQ (Basic Allowance for Quarters). You may deduct mortgage interest and real estate taxes on your home even if you pay these expenses with BAQ funds.
- BAS (Basic Allowance for Subsistence) living allowances.
- Housing and cost-of-living allowances abroad, whether paid by the U.S. Government or by a foreign government.
- VHA (Variable Housing Allowance).
- Family allowances for educational expenses for dependents, emergencies, evacuation to a place of safety, and separation.
- Death allowances for burial services, death gratuity payments to

eligible survivors (not more than \$3,000), and travel of dependents to burial site.

- Dislocation allowance, intended to partially reimburse expenses such as lease forfeitures, temporary living charges in hotels, and other expenses incurred in relocating a household.
- Temporary lodging expense allowance intended to partially offset the added living expenses of temporary lodging within the United States for up to 10 days and up to 60 days abroad.
- A moving-in housing allowance, intended to defray costs, such as for rental agent fees, home-security improvements, and supplemental heating equipment, associated with occupying leased space outside the United States.
- Travel allowances for annual round trip for dependent students, leave between consecutive overseas tours, reassignment in a dependent-restricted status, and transportation for you or your dependents during ship overhaul or inactivation.
- Defense counseling payments.
- ROTC educational and subsistence allowances.
- Survivor and retirement protection plan premium payments.
- Uniform allowances paid to officers and uniforms furnished to enlisted personnel.
- Medical or hospital treatment provided by the United States in government hospitals.
- Pay forfeited on order of a court martial.
- Education, training, or subsistence allowances paid under any law administered by the Department of Veterans Affairs (VA). However, deductible education costs must be reduced by the VA allowance.
- Adjustments in pay to compensate for losses resulting from inflated foreign currency.
- Payments to former prisoners of war from the U.S. Government in compensation for inhumane treatment suffered at the hands of an enemy government.
- Benefits under Servicemembers' Group Life Insurance.
- Dividends on GI insurance. These are a tax-free return of premiums paid.
- Interest on dividends left on deposit with the Department of Veterans Affairs (VA). The IRS has revoked a prior ruling that subjected such interest to tax.

Disability retirement pay. Your disability retirement pay may be tax free if you are a former member of the Armed Forces of any country, the Foreign Service, the Coast Guard, the National Oceanic and Atmospheric Administration, or the Public Health Service; *see* ¶2.13. Tax-free treatment of disability retirement pay is retroactive to the date of the application for benefits.

¶35.3 Deductions for Armed Forces Personnel

Members of the Armed Services may deduct the items listed below as miscellaneous itemized deductions subject to the 2% adjusted gross income (AGI) floor; *see* ¶19.1:

- Board and lodging costs over those paid to you by the government while on temporary duty away from your home base.

- Costs of rank insignia, collar devices, gold braids, etc. and the cost of altering rank insignia when promoted or demoted.
- Contributions to a “Company” fund made according to Service regulations. But personal contributions made to stimulate interest and morale in a unit are not deductible.
- Court martial legal expenses in successfully defending against the charge of conduct unbecoming an officer.
- Dues to professional societies. But you may not deduct dues for officers’ and noncommissioned officers’ clubs.
- Expense of obtaining increased retirement pay.
- Out-of-pocket moving expenses for service-connected moves. The 50-mile test and the 39-week test generally required to deduct moving expenses do *not* have to be met; *see* ¶21.1.
- Subscriptions to professional journals.
- Transportation, food, and lodging expenses while on official travel status. But you are taxed on mileage and *per diem* subsistence allowance.
- Travel expenses while ship or squadron is “away from home” post or base. However, you are not considered “away from home” if you are at your *permanent* duty station or you are a naval officer assigned to *permanent* duty aboard a ship; *see also* ¶20.6.
- Uniforms. The cost and cleaning of uniforms are deductible if: (1) they must be worn on duty; (2) they cannot under military regulations be worn off duty; and (3) the cost exceeds any tax-free clothing allowance.

pay received for each month during any part of which you served in a combat zone or hazardous duty area. Currently, the highest level of basic pay is \$4,259.90 per month.

If you are a commissioned warrant officer, you are considered an enlisted person.

What is included as tax-free pay? The following military pay qualifies for tax-free treatment: (1) active duty pay earned in any month you served in a combat zone or hazardous duty area; (2) a dislocation allowance if the move begins or ends in a month you served in a combat zone or hazardous duty area; (3) a reenlistment bonus if the voluntary extension or reenlistment occurs in a month you served in a combat zone or hazardous duty area; (4) pay for accrued leave earned in any month you served in a combat zone or hazardous duty area (the Department of Defense must determine that the unused leave was earned during that period); (5) pay received for duties as a member of the Armed Forces in clubs, messes, post and station theaters, and other nonappropriated fund activities. The pay must be earned in a month you served in a combat zone or hazardous duty area; and (6) awards for suggestions, inventions, or scientific achievements you are entitled to because of a submission you made in a month you served in a combat zone or hazardous duty area.

Service in the combat zone or hazardous duty area includes any periods you are absent from duty because of sickness, wounds, or leave. If, as a result of serving in a combat zone, you become a prisoner of war or missing in action, you are considered to be serving in the combat zone as long as you keep that status for military pay purposes.

Combat zone must be designated by President. A combat zone is any area the President of the United States designates by Executive Order as an area in which the U.S. Armed Forces are or have engaged in combat. An area becomes a combat zone and ceases to be a combat zone on the dates designated by the President.

A special law designates Bosnia and Herzegovina, Croatia, and Macedonia as a hazardous duty area.

Qualifying service outside combat zone or hazardous duty area. Military service outside a combat zone or hazardous duty area is considered to be performed in a combat zone or hazardous duty area if: (1) the service is in direct support of military operations in the combat zone or hazardous duty area, and (2) the service qualifies you for special military pay for duty subject to hostile fire or imminent danger. Military pay received for this service will qualify for the pay exclusion if the other requirements are met.

Nonqualifying service. The following military service does not qualify as service in a combat zone or hazardous duty area: (1) presence in a combat zone while on leave from a duty station located outside the combat zone; (2) passage over or through a combat zone during a trip between two points that are outside a combat zone; and (3) presence in a combat zone solely for your personal convenience.

Such service will not qualify you for the pay exclusion.

¶35.4 Tax-Free Pay for Service in Combat Zone or Hazardous Duty Area

If your grade is below commissioned officer and you serve in a designated combat zone or hazardous duty area during any part of a month, *all* of your qualifying military pay (*see* in the next column) for that month is excluded from your taxable income. You may also exclude military pay earned during any part of a month that you are hospitalized as a result of wounds, disease, or injury incurred in a combat zone or hazardous duty area. The exclusion for military pay while hospitalized does not apply to any month that begins more than two years after the end of combat activities in that combat zone or hazardous duty area. Your hospitalization does not have to be in the combat zone or hazardous duty area.

Members of the U.S. Armed Forces qualifying for the exclusion include commissioned officers and enlisted personnel in all regular and reserve units under control of the Secretaries of Defense, Army, Navy, and Air Force, and the Coast Guard. Members of the U.S. Merchant Marines or the American Red Cross are not included.

Officers. If you are a commissioned officer, you may exclude up to the highest rate of basic pay at the highest pay grade that enlisted personnel receive per month plus any hostile fire/imminent danger



Combat Zones and Hazardous Duty Area

The following locations (including airspace) were designated as combat zones beginning January 17, 1991: the total land areas of Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar, and the United Arab Emirates; the Persian Gulf; the Red Sea; the Gulf of Oman; the part of the Arabian Sea that is north of 10 degrees north latitude and west of 68 degrees east longitude; and the Gulf of Aden.

An exclusion is also available for service outside the designated areas if it was in direct support of combat zone military operations and qualified you for special hostile fire pay. At the time this book went to press, the Persian Gulf area continued to be a combat zone.

By law, Bosnia and Herzegovina, Croatia, and Macedonia were designated as a qualified hazardous duty area, service in which entitles service personnel to combat pay tax benefits.

Hospitalized while serving in a combat zone or hazardous duty area. If you are hospitalized while serving in a combat zone or hazardous duty area for a wound, disease, or injury, it will be presumed to have been incurred while serving in the combat zone or hazardous duty area unless there is clear evidence to the contrary.

EXAMPLES

1. You are hospitalized for a specific disease after serving in a combat zone for three weeks, and the disease for which you are hospitalized has an incubation period of two to four weeks. The disease is presumed to have been incurred while you were serving in the combat zone. On the other hand, if the incubation period of the disease is one year, the disease would not have been incurred while you were serving in the combat zone.
2. You were hospitalized for a specific disease three weeks after you left the combat zone. The incubation period of the disease is from two to four weeks. The disease is considered to have been incurred while serving in the combat zone.

Form W-2. The wages shown in Box 1 of your Form W-2 should not include combat pay. Retirement pay is not combat pay.

¶35.5 Tax Deadlines Extended for Combat Zone or Hazardous Duty Area Service

You are allowed an extension of at least 180 days (*see* the next column) to take care of tax matters if you are a member of the Armed Forces who served in a combat zone or hazardous duty area. The extension applies to filing tax returns, paying taxes, filing a Tax Court petition, filing refund claims, making an IRA contribution, and purchasing a new home for tax deferral (¶29.2) purposes. The

time allowed for the IRS to begin an audit or take collection actions is also extended.

Support personnel. The deadline extension also applies if you are serving in a combat zone or hazardous duty area in support of the Armed Forces. This includes Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces in support of those forces.

Extension is minimum of 180 days. Your deadline for taking actions with the IRS is extended for at least 180 days after the later of: (1) the last day you are in a combat zone or hazardous duty area (or the last day it qualifies as a combat zone or hazardous duty area), and (2) the last day of any continuous qualified hospitalization for injury from service in the combat zone or hazardous duty area. Hospitalization may be outside the United States, or up to five years of hospitalization in the United States.

Time in a missing status (missing in action or prisoner of war) counts as time in a combat zone or hazardous duty area.

In addition to the 180 days, your deadline is also extended by the number of days you had left to file with the IRS when you entered a combat zone or hazardous duty area. If you entered the combat zone or hazardous duty area before the time to file began, the deadline is extended by the entire filing time.

Spouses of combat zone personnel. If your spouse serves in a combat zone or hazardous duty area, you are generally entitled to the same deadline extension as he or she is. However, any extra extension for your spouse's hospitalization within the United States is not available to you. Further, a spouse's extension does not apply to any year beginning more than two years after the end of combat or hazardous duty activities.

¶35.6 Tax Forgiveness for Combat Zone or Hazardous Duty Area Deaths

If a member of the Armed Forces is killed in a combat zone or hazardous duty area or dies from wounds or disease incurred while in these zones or areas, any income tax liability for the year of death or any earlier year including service in such zones or areas is waived. In addition, the service member's estate is entitled to a refund for income tax paid while serving there.

If a member of the Armed Forces was a resident of a community property state and his or her spouse reported half of the military pay on a separate return, the spouse may get a refund of taxes paid on his or her share of the combat zone or hazardous duty area pay.

Forgiveness benefits apply to an Armed Forces member serving outside the zone or area if service: (1) was in direct support of military operations there, and (2) qualified the member for special military pay for duty subject to hostile fire or imminent danger.

Missing status. The date of death for a member of the Armed Forces who was in a missing status (missing in action or prisoner of war) is the date his or her name is removed from missing status for military pay purposes. This is true even if death occurred earlier.

How tax forgiveness is claimed. If the individual died in a combat zone or in a terroristic or military action, you file as the individual's representative: (1) Form 1040 if a U.S. individual income tax return (Form 1040, 1040A, or 1040EZ) has not been filed for the tax year. Form W-2, Wage and Tax Statement, must accompany the return. (2) Form 1040X if a U.S. individual income tax return has been filed. A separate Form 1040X must be filed for each year in question.

Check with your local IRS office for the address of the IRS office to which the return is filed.

An attachment should accompany any return or claim and should include a computation of the decedent's tax liability before any amount is forgiven and the amount that is to be forgiven.

The following documents must also accompany all returns and claims for refund: (1) Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer; and (2) a certification from the Department of Defense. Department of State certification is required if the decedent was a civilian employee of an agency other than the Department of Defense.

Tax abatement for civilian or military personnel killed in terroristic or military action. Tax liability is waived for civilian or military U.S. employees killed in terroristic or military actions outside the U.S., even if the President has not designated the area as a combat zone and it is not a hazardous duty area. Tax liability is waived for the period beginning with the taxable year before the year in which the injuries were incurred and ending with the year of death. Refund claims for prior years must generally be filed on Form 1040X by the later of three years from the time the original return was filed or two years from the time the tax was paid. However, if death occurred in a combat zone, the filing period is extended by the time served in the combat zone, plus the period of continuous hospitalization outside the U.S., plus an additional 180 days. The individual must also be a U.S. employee both on the date of injury and date of death.

Tax abatement does not apply to a U.S. civilian or military employee who dies as a result of an accident or a training exercise. Abatement also does not apply to terroristic action within the United States. However, abatement does apply if the individual dies in the U.S. from a wound or injury incurred in a terroristic or military action outside the United States.

Determination of death for Vietnam MIAs. Under prior law, MIAs were generally presumed dead as of December 31, 1982. Under current law, the date of death of service members missing in action in Vietnam is the date determined by the Armed Forces. Thus, under current law, tax abatement may be available for years after 1982. Furthermore, the date of death, as determined by the Armed Forces, also applies for such rules as whether to file as a surviving spouse, and for postponing the due date for filing returns and paying taxes.

service ends. Get a form at the IRS office of your District Director or write a letter to the District Director or to the IRS office requesting payment (your spouse or parent may do it for you). An extension, without interest, may be given if your income dropped after entering the military *and* you actually apply for the extension.

The extension does not cover your spouse, who must file a separate return and pay the tax due. But you and your spouse may file a joint return before the postponement period expires even though your spouse filed a separate return for that particular year. No interest is charged on this postponement of your tax.

Automatic extension of time to file your return. If you are on duty outside the U.S. or Puerto Rico on April 15, 1997, you get an automatic two-month extension to file your 1996 return; *see* page 5.

Interest charged on back taxes. If you do not show hardship qualifying you for the above interest-free payment extension, the IRS may reduce its interest rate on the deficiency. The maximum interest rate the IRS may charge for taxes incurred prior to your entry into active service is 6%. This reduced rate applies only to the period of your active duty.

¶35.8 Tax Information for Reservists

Transportation costs to reservist meetings generally are not deductible. A possible exception is the cost of traveling from your regular job location to a meeting held on a regular workday. The cost would be deductible, subject to the 2% adjusted gross income (AGI) floor for miscellaneous itemized deductions; *see* ¶19.1.

If you travel overnight away from your tax home (¶20.6) to a meeting or training camp, you may deduct expenses for transportation, lodging, and meals subject to the 50% reduction.

If you are called for active duty away from your tax home, you may deduct travel expenses provided you keep your regular job while on active duty, return to it after you are released, and pay for those expenses at the military post. To the extent they exceed BAQ (quarters) and BAS (subsistence) allowances, the expenses are deductible only as a miscellaneous itemized deduction subject to the 2% AGI floor.

Uniform costs. The cost and upkeep of uniforms is deductible only if you are prohibited from wearing them when off duty; *see* ¶19.6. A deduction allowed under this test must be reduced by any uniform allowance you receive, and the unreimbursed cost is subject to the 2% adjusted gross income (AGI) floor for miscellaneous itemized deductions.

Deferring tax payments and reduction of IRS interest rate. If you owed a tax deficiency to the IRS before being called to active duty, the IRS may defer payment, without interest, if your ability to pay has been severely impaired by your call-up. If you are not allowed a deferment, the IRS will reduce its interest charge to 6% on the taxes you owed before your call-up.

¶35.7 Extension To Pay Your Tax When Entering the Service

If you are unable to pay your tax when you enter the Armed Forces, you may get an extension until six months after your initial period of